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In the

Supreme Court of the United States

KENCO RESTAURANTS, INC. ; K-K RESTAURANTS, INC. ;
TIFFIN AVENUE REALTY COMPANY, INC. ;
BRYAN REALTY, INC. ,

Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

I. WHETHER THE SIXTH CIRCUIT HAS MISAPPLIED THE BURDEN(S) OF PROOF AND PRODUCED AN INEQUITABLE OUTCOME

II. WHETHER THE COMMISSIONER'S REALLOCATIONS IN THE NODS LOST THEIR PRESUMPTION OF CORRECTNESS WHEN SHE ABANDONED HER REVENUE AGENT AT TRIAL

PARTIES TO THE PROCEEDINGS

Kenco Restaurants, Inc.; K-K Restaurants, Inc.; Tiffin Avenue Realty Company, Inc.; and Bryan Realty, Inc. are not publicly-owned and none has a publicly-owned parent or a non-wholly owned subsidiary.

TABLE OF CONTENTS

QUESTIONS PRESENTED i

PARTIES TO THE PROCEEDINGS ii

TABLE OF CONTENTS iii

TABLE OF AUTHORITIES iv

OPINIONS BELOW 1

JURISDICTION 1

RELEVANT CONSTITUTIONAL , STATUTORY ORDINANCE PROVISIONS INVOLVED 2

STATEMENT OF THE CASE 2

REASONS FOR GRANTING THE WRIT 8

CONCLUSION 24

APPENDIX

CIRCUIT COURT OPINION 1a

TAX COURT MEMO 18a

TRANSCRIPT EXCEPRTS 36a

TABLE OF AUTHORITES

CASES

BRYAN REALTY, INC. V. COMMISSIONER OF INTERNAL REVENUE, 206 F.3D 588 (6TH CIR. 2000) 1

BRYAN REALTY, INC. V. COMMISSIONER OF INTERNAL REVENUE, T.C. MEMO 1998-342 ..... 1, 9

DHL CORP., ET AL. V. COMMISSIONER, TC MEMO 1998-461 (1988)..... passim

ELI LILLY & COMPANY, ET AL. V. COMMISSIONER, 856 F.2D 855 (7TH CIR. 1988)..... passim

FOSTER V. COMMISSIONER, 756 F.2D 1430, 1432 (9TH CIR. 1985, *CERT. DENIED*, 474 U.S. 1055 (1986) 9

HULL V. COMMISSIONER, 87 F.2D 260 (4TH CIR. 1937)..... 16

NATIONAL SEMICONDUCTOR CORP., ET AL. V. COMMISSIONER, T.C. MEMO 1994-195 (1994)..... 9, 10, 17

PIKEVILLE COAL CO. ET AL. V. UNITED STATES, 37 FED. CL. 304 (1997)..... 10

POWERS V. COMMISSIONER, 724 F.2D 64, 66 (7TH CIR. 1983)9

SEAGATE TECHNOLOGY V. COMMISSIONER OF INTERNAL REVENUE, 102 T.C. 149 (1994) 10

SPICER THEATRE, INC. V. COMMISSIONER, 346 F.2D 704, 706 (6TH 1965)..... 9

SUNDSTRAND CORPORATION, ET AL. V. COMMISSIONER, 96 T.C. 226, 353 (1991)..... 10

WELCH V. HELVERING, 290 U.S. 111, 115 (1933) 9

ZARIN V. COMMISSIONER, 92 T.C. 68 (1989), REV'D ON OTHER GROUNDS, 916 F.2D 110 (3RD CIR. 1990) 16

STATUTES

26 U.S.C. SECTION 482 ..... passim

28 U.S.C. SECTION 1254(1) 1

28 U.S.C. SECTION 2101(C) 1

INTERNAL REVENUE CODE - 26 2

SUPREME COURT RULE 10(A) 1

OPINIONS BELOW

Four cases were consolidated for trial and appeal. The opinion of the United States Court of Appeals for the Sixth Circuit in *Kenco Restaurants, Inc.; K-K Restaurants, Inc.; Tiffin Avenue Realty Company, Inc; and Bryan Realty, Inc. v. Commissioner of Internal Revenue*, 206 F.3d 588 (6th Cir. 2000), is set forth in the Appendix hereto (APP 1a).

The Memorandum Findings of Fact and Opinion of the United States Tax Court in *Kenco Restaurants, Inc.; K-K Restaurants, Inc.; Tiffin Avenue Realty Company, Inc; and Bryan Realty, Inc. v. Commissioner of Internal Revenue*, T.C. Memo 1998-342 (9/24/98) is set forth in the Appendix hereto (APP 18).

BASIS FOR JURISDICTION

The final judgment of the United States Court of Appeals for the Sixth Circuit affirming the decision of the United States Tax Court was entered on February 16, 2000 (APP 1a). This petition for writ of certiorari is filed within ninety (90) days from that date. 28 U.S.C. Section 2101(c).

The jurisdiction of this Court is invoked pursuant to the provisions of 28 U.S.C. Section 1254(1).

The Considerations Governing Review on Certiorari as a matter of judicial discretion is that the United States Court of Appeals for the Sixth Circuit has entered a decision in conflict with precedent of the United States Court of Appeals for the Seventh Circuit in *Eli Lilly & Company, et al. v. Commissioner*, 856 F.2d 855 (7th Cir. 1988). Supreme Court Rule 10(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED.

Internal Revenue Code - 26 U.S.C. Section 482:

Allocation of income and deductions among taxpayers.

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

STATEMENT OF THE CASE

These cases concern the propriety of the Commissioner's reallocation of the costs of a management company among several related corporations for the tax years 1990, 1991 and 1992 pursuant to 26 U.S.C. Section 482.

Consolidated trial on the merits in the United States Tax Court, the Honorable Judge Halpren presiding, resulted in Decisions in favor of the Commissioner on September 28, 1998. The taxpayers appealed to the United States Court of Appeals for the Sixth Circuit which affirmed the Tax Court.

STATEMENT OF THE FACTS

The taxpayers are part of a group of 13 corporations owning and operating Taco Bell restaurants throughout Ohio and/or holding the underlying real estate for some of the operating restaurants. Another related corporation providing the management and administrative services, BKK Management, Inc. ("BKK"), did not own or operate any restaurant or realty corporations. For the tax years involved, all group members were owned in equal shares by three men, either individually or with their wives (collectively the "Owners"). Two of the Owners provided operational management of restaurants and worked full-time for BKK. The third Owner, an attorney who worked half-time for BKK, was responsible for the group's administrative and legal needs.

The costs of operating BKK, "payroll-related" (BKK's gross payroll, payroll taxes and health insurance) and "incidental" (BKK's office rent, office supplies, etc.), were allocated among the related corporations. Incidental costs were allocated using a simple weighting system designed to approximate consumption by the related corporations. Payroll-related costs were allocated on the basis of the number of hours that the Owners spent at or on behalf of each of the related corporations based on 6,000 annual hours dedicated each year by the Owners. 5,000 hours were allocated to specific corporations (the "direct" hours) and

1,000 hours were applicable to all corporations (the "indirect" hours). The indirect hours were allocated in the same ratio as the direct hours.

The total Owner hours for each corporation for each tax year were initially estimated at the beginning of each tax year (using the number of hours spent the previous year as the starting point), with the projected hours contemporaneously recorded on computer spreadsheets prepared and developed for that purpose by Ms. Nancy Borsani, BKK's accountant. These estimates were subsequently and continuously examined and revised. At mid-year, an evaluation was conducted to determine whether the actual hours were close to the projected hours and adjustments were made as necessary depending upon the experience to date for the first half of the year, and any changes in the projections for the remaining half of the year. Through regular reporting to and interaction among themselves and with Ms. Borsani, the Owners were able to monitor actual and anticipated events and develop reasonable estimates of the allocation of their time among the corporations. In result, their almost daily contact made maintaining written time logs of actual hours spent on various activities superfluous - they worked together in the same office and conferred regularly as to their activities. (TR 81-82, L 14-18, APP 36a-37a). The allocated costs were actually paid by check by the related corporations as they were incurred -- on a pay-as-you-go basis -- every week. There was never an adjustment made based on the inability of any corporation to pay its cost share.

The original BKK computer spreadsheets were amended by the taxpayers to add captions and explanations after the case was transferred from Examination to Appeals. Because the original BKK computer spreadsheets were not

"saved" before the additional explanatory information was incorporated, they were destroyed. However, all numerical data and the actual allocation percentages in the original BKK computer spreadsheets were preserved and not altered in the restructured spreadsheets.

The allocation of Owner service hours was based on: actual hours; historical experience; evaluations/adjustments on a regular, on-going basis; and evaluations and adjustments at mid- year based on actual experience.

The only substantive, factual evidence introduced at trial was that of the Owners and the corporate accountant (Nancy Borsani). The Commissioner never contested: (1) the number of annual hours invested by the Owner for any year, or (2) the total costs of BKK that were allocated among the corporations.

At trial, the Commissioner proffered the opinion of her expert, Alpha Consulting Alliance ("ACA") as representing the position of the Government. In doing so, the revenue agent, Diane Camper, testified briefly, but was dismissed when the Tax Court brought her cross-examination to a close in holding:

> The [Commissioner] has not put forward the revenue agent's allocations as representing the market value. They've got an expert who they say is going to do that who came up with different allocations than the revenue agent.

(TR 230, L 20-24, APP 38a).

As a result, it is submitted that the Commissioner abandoned its Revenue Agent's reallocation methodology,

and, instead, relied upon her expert, ACA. This was fortunate for the taxpayers as their effort to qualify an expert of their own on the issue was unsuccessful; abandonment altered the burden of proof; and because ACA's opinion supported the taxpayers in theory and result and satisfied an otherwise onerous burden.

ACA agreed that the taxpayers' method of allocating overhead costs on the basis of the number of hours of service provided to each of the corporations is a reasonable method of allocating such costs. ACA adjusted neither the total dollars allocated nor the total hours of the Owners. Instead, among other flaws, ACA merely "backed in" more hours into its computations by including the projected hours of selected second- and third-tier, modestly compensated employees -- a district manager, a maintenance man, and BKK's in-house accountant (who was not even employed at BKK throughout the pertinent periods).

ACA found that a "comparison between locations on the basis of estimated valuation conclusions *appear to most closely support the allocations presented by management*" and "did not challenge the overall methodology based on time." (TR 294, L 13-23, APP 40a (emphasis added)). ACA concluded that allocating overhead costs on the basis of service hours allocable to each of the corporations is a reasonable method. (TR 297, L 11-17, APP 42a-43a).

ACA changed neither the total dollars allocated, (TR 295, L 17-23, APP 41a), nor the per hour allocation (although ACA effectively cut this in half by doubling the hours in its allocation formula), (TR 295-296, L 24-2, APP 41a), and concluded that the overall hours of the Owners were reasonable, (TR 296, L 11-13, APP 42a).

In its analysis, ACA relied upon the Robert Morris Associates Industry Guidelines (the "RMA") in evaluating an arm's length standard. ACA, however, perverted the RMA data, which is based on officer compensation costs -- strictly upper management level, (TR 303, L 17-19, APP 44a), by including non-officer compensation costs.

In essence, ACA used "certain financial analysis and fluctuating industry norms to criticize the results [the taxpayers'] got without being able to say with any degree of confidence that they simply didn't do things the way they said." (TR 323, L 9-22, APP 44a-45a ; TR 325, L 4-6, APP 45a). It is apparent that ACA started with its desired results and derived the number of hours that it deemed appropriate for that result. It did not start with the number of hours and answer the question as to whether those hours were spent as the taxpayers testified they were. (TR 335, L 8-19, APP 49a-50a).

At trial, the Commissioner was compelled to concede that the adjustments in the Notices of Deficiency do not reflect the conclusions of ACA. (TR 327, L 14-19, APP 47a).

In its Memorandum Opinion, the Tax Court held that in order for the Court to redetermine a Section 482 deficiency, the taxpayers bear the heavier than normal burden of proving that the Commissioner's allocation is arbitrary, capricious or unreasonable. (Opinion at 9, APP 26).

Recognizing an "ambiguity" in the case law interpreting Section 482 - whether the taxpayer must prove that (1) the amount of the Commissioner's allocation is arbitrary, capricious or unreasonable, or (2) whether the method or theory of the reallocation was arbitrary, capricious

or unreasonable (Opinion at 13, fn. 2, APP 35) -- the Court held it moot ruling that the taxpayers did not direct any argument to proving the Commissioner's method (revenue agent Camper's gross sales method) produces an arbitrary, capricious or unreasonable result, to wit "that gross sales is not indicative of management and administrative services provided." *Id.*

The taxpayers appealed to the United States Court of Appeals for the Sixth Circuit which affirmed the Tax Court holding that: 1) the IRS had not abandoned its notices of deficiency ("NODs"); 2) the taxpayers failed to carry their burdens of proof, and; 3) the imposition of accuracy-related penalties was appropriate.

REASONS FOR GRANTING THE WRIT.

I. THE APPLICABLE BURDENS OF PROOF

Section 482 is a broad statute that enables the Commissioner to reallocate income and deductions among related entities when she deems such reallocation necessary to clearly reflect income. The statute can be and is applied in a wide variety of settings. Section 482 reallocations can involve the transfer of tangible or intangible property. They can also involve the charges for rendering services or lending money. Section 482 can be applied in transactions involving domestic and/or foreign entities. Because of the potential to shift income earned in the United States to lower-tax regimes, most significant transactions involving a related foreign entity are scrutinized for possible Section 482 reallocations. As commerce becomes increasingly global, Section 482 becomes increasingly significant.

The dollars involved in Section 482 reallocations can be enormous and tax deficiencies in the tens of millions of dollars are common.[1] Section 482 is not a taxpayer-friendly provision and taxpayers bear a very heavy burden of proof in Section 482 controversies. Unfortunately, this heavy burden is qualitative and often poorly articulated. While the tax dollars herein are modest relative to many other Section 482 cases, the principles involved are extremely important and will have significant impact in future cases.

A reallocation by the Commissioner under Section 482 is presumptively correct[2] and, in order to rebut that presumption, a taxpayer must demonstrate that the IRS's reallocation is "arbitrary, capricious, or unreasonable."[3] The manner in which both the Tax Court and the Sixth Circuit interpreted this initial burden of proof herein illustrates just how onerous and how unclear that burden is.

The correct burdens of proof are enunciated in the Seventh Circuit, in *Eli Lilly & Co.*, which, upon reviewing the relevant case law, held that a taxpayer's burden of proof under Section 482 has two elements:

> The Commissioner exercises broad authority under section 482. The courts will overrule a

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[1] *See, e.g., Eli Lilly & Company, et al. v. Commissioner*, 856 F.2d 855 (7th Cir. 1988); *DHL Corp., et al. v. Commissioner*, T.C. Memo 1998-461 (1998); *National Semiconductor Corp., et al. v. Commissioner*, T.C. Memo 1994-195 (1994).

[2] *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

[3] *Eli Lilly & Co.*, 856 F.2d 855, 860 (7th Cir. 1988); *Foster v. Commissioner*, 756 F.2d 1430, 1432 (9th Cir. 1985, *cert. denied*, 474 U.S. 1055 (1986); *Powers v. Commissioner*, 724 F.2d 64, 66 (7th Cir. 1983); *Spicer Theatre, Inc. v. Commissioner*, 346 F.2d 704, 706 (6th 1965).

> section 482 reallocation by the Commissioner only if it is found to be arbitrary, capricious or unreasonable. [Citations omitted.] When a taxpayer rebuts the presumption of reasonableness afforded the Commissioner's determinations, [citations omitted], the Tax Court (or district court) must determine whether the taxpayers own allocations conform to the arm's length requirement.

856 F.2d at 860.

In essence, the taxpayer has two separate burdens of proof. First, the taxpayer must demonstrate that the Commissioner's reallocation is arbitrary, capricious, or unreasonable. Should the taxpayer prevail, the second burden of proof arises. Then the taxpayer has the opportunity to demonstrate that its own allocations conform to an arm's length transfer price. Significantly, if the taxpayer carries the first burden, but not the second, *Eli Lilly & Co.* correctly holds that the trial court is to make the proper reallocation.

The Seventh Circuit's dual-burden *Eli Lilly & Co.* standard has been, for the most part, uniformly applied.[4] Here, the Sixth Circuit ostensibly adopted it, but reduced the *Eli Lilly & Co.* standard to a single, very different, burden.

Here, the taxpayers met their initial burden upon two showings at trial: (1) the Commissioner abandoned her NODs; and (2) the Commissioner's expert, ACA, ultimately

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[4] *Pikeville Coal Co. et al. v. United States*, 37 Fed. Cl. 304 (1997); *National Semiconductor Corp. v. Commissioner*, T.C. Memo 1994-195 (1994); *Seagate Technology v. Commissioner*, 102 T.C. 149 (1994); *Sundstrand Corporation, et al. v. Commissioner*, 96 T.C. 226, 353 (1991).

proved that the NODs were arbitrary, capricious or unreasonable.

II. THE SIXTH CIRCUIT HAS MISAPPLIED THE BURDEN(S) OF PROOF AND PRODUCED AN INEQUITABLE OUTCOME

If the Commissioner is deemed not to have abandoned the NODs, the taxpayers have to demonstrate that the Section 482 reallocations in the NODs were arbitrary, capricious or unreasonable. This task was exacerbated for at least three reasons.

First, the Section 482 reallocations in the NODs differed from revenue agent Camper's proposed reallocations without explanation of the manner in which the reallocations in the NODs were made.

Second, the Commissioner introduced no evidence as to how the Section 482 reallocations in the NODs were made. The only document the Commissioner attempted to introduce at trial was deemed inadmissible for authenticity reasons. Revenue agent Camper's direct testimony was cursory at best, did not involve any records or documents, and failed to "put in one wick of evidence." (TR 231, L 3-4, APP 39a).

Third, when taxpayers' counsel attempted to ascertain how revenue agent Camper had established her arm's length price, he was admonished by the trial judge that such a line of questioning was irrelevant since the Commissioner had an expert that would support a different arm's length price - it was a finding of abandonment and a release of the burden of proving the arbitrary, capricious or unreasonable method that it was.

In short, the taxpayers found it difficult to challenge the Section 482 reallocations in the NODs for the simple reason that there was virtually nothing to challenge. Taxpayers should not have to bear a burden of demonstrating what the Commissioner did and how she did it before they undertake the real burden of demonstrating that what the Commissioner did was arbitrary, capricious, or unreasonable. The taxpayers did not know how the Section 482 reallocations in the NODs were arrived at nor were they able to deduce or elicit those facts at trial. Thus, the taxpayers did what they had to do -- vigorously challenge the analyses and testimony of ACA.

The Sixth Circuit's decision may seem to have adopted the Seventh Circuit's *Eli Lilly & Co.'s* dual burden-of-proof requirement. However, the Sixth Circuit actually departed from *Eli Lilly & Co.* and created a new and incorrect standard. There is now a major conflict between the Sixth Circuit and at least the Seventh Circuit as to taxpayers' burden(s) of proof in a Section 482 controversy.

The Sixth Circuit summarized the burden(s) of proof facing the taxpayers as follows:

> The second issue we address is whether [the taxpayers] have shown that the reallocations contained in the notice of deficiency are arbitrary, capricious, or unreasonable. Because deficiency notices have a presumption of correctness, [the taxpayers] have the burden of overcoming this presumption by proving that their initial allocations were arm's length.

(APP 10).

The Sixth Circuit has seriously misstated the *Eli Lilly & Co.* burden-of-proof which is clearly and correctly articulated. Taxpayers must first demonstrate that the Commissioner's reallocations are arbitrary, capricious, or unreasonable. The second burden, which arises only if taxpayers meet the first burden, requires taxpayers to prove that their own allocations satisfy the arm's length standard. However, a taxpayer's failure to carry the second burden is not fatal under *Eli Lilly & Co.* If a taxpayer cannot demonstrate that its own allocations meet the arm's length standard then, according to *Eli Lilly & Co.*, it is incumbent on the trial court to ascertain an appropriate transfer price. Interestingly, the Sixth Circuit recognized these principles, but failed to apply them, effectively merging the two burdens.

In discussing the taxpayer's first burden, the Sixth Circuit cited *DHL Corp.*, for the proposition that, "[t]o prove arbitrary, capricious, or unreasonable, [taxpayers] *must* show that their own allocations reflect an arm's-length charge." (Emphasis added.) .

The Sixth Circuit's interpretation of *DHL Corp.* is incorrect in that *DHL Corp.* did not contain a mandate. What *DHL Corp.* actually said was that:

> [a taxpayer's] burden is to show that each section 482 adjustment is arbitrary, capricious, and unreasonable. To do that, taxpayers *normally* show that the questioned transactions were conducted under an arm's length standard.

1998 T.C. Memo at 98-2759 (Emphasis added.)

There is a major distinction between what taxpayers "must" do (the Sixth Circuit's version of *DHL Corp.*) and what taxpayers "normally" do (what *DHL Corp.* actually said).

When a taxpayer demonstrates that its own allocations meet the arm's length standard, that should be adequate to demonstrate that the Section 482 reallocations by the Commissioner are unreasonable. If the taxpayer carries the second burden, he should be deemed to have carried the first burden. But, considering the two burdens separately, if the taxpayer fails to carry the second burden, no conclusion can be drawn as to whether the first burden has been carried. In short, the Commissioner should not prevail entirely when both it and the taxpayer are wrong!

If the Sixth Circuit's interpretation of *DHL Corp.* were correct, the first burden of *Eli Lilly & Co.* would be moot. Under the Sixth Circuit's interpretation, taxpayers would satisfy both the first and the second burdens by demonstrating that their own allocations reflect an arm's length charge (the second burden in *Eli Lilly & Co.*). However, *Eli Lilly & Co.* clearly indicates that a taxpayer could meet the first burden without meeting the second. In other words, *Eli Lilly & Co.* allows for the very real possibility that both the government's reallocation and the taxpayer's initial allocation are substantially wrong.

Under *Eli Lilly & Co.*, when a taxpayer carries the first burden but fails to carry the second burden, the trial court is to determine the appropriate transfer price. And, the appropriate transfer price might be significantly closer to the taxpayer's transfer price than to the transfer price resulting from the Section 482 reallocation by the Commissioner. According to the Sixth Circuit, the taxpayer fails to carry the

critical first burden by virtue of failing to carry the second burden. And, when a taxpayer fails to carry the first burden, the presumption of correctness for the Commissioner's reallocation becomes absolute.

Under the Sixth Circuit's standard, the Commissioner's reallocation is upheld in its entirety when the taxpayer fails to carry the second burden because that failure is deemed to be a failure to carry the first burden. When the IRS reallocation is "a lot" wrong while the taxpayer's initial allocations is only "a little" wrong, the Seventh Circuit's *Eli Lilly & Co.* decision produces a sound answer while the Sixth Circuit's interpretation of *DHL Corp.* produces a bad one.

Because the Sixth Circuit's view of the taxpayers' burdens of proof herein can produce an inequitable result and conflicts with the established and well-reasoned opinion of the Seventh Circuit in *Eli Lilly & Co.*, this Honorable Court should grant the Petition for Writ of Certiorari.

III. THE COMMISSIONER'S REALLOCATIONS IN THE NODS LOST THEIR PRESUMPTION OF CORRECTNESS WHEN SHE ABANDONED HER REVENUE AGENT AT TRIAL

A Section 482 controversy is complicated by the uncertainty as to what constitutes the Government's "reallocation." Here, the Commissioner produced ACA's transfer price study approximately 30 days before trial. This study took a fundamentally different approach than that undertaken by her revenue agent, Diane Camper and came to a significantly different result. Both ACA and the taxpayers employed a time-based methodology whereas that used by revenue agent Camper was based on relative gross sales.

Because of the Tax Court's termination of the cross-examination of revenue agent Camper, neither it nor the Sixth Circuit came to appreciate that the deficiencies set forth in the NODs differed from the deficiencies originally proposed by revenue agent Camper. This is because revenue agent Camper's original proposed Section 482 reallocations had been adjusted by an Appeals Officer. It is the Appeals Officer's recalculated Section 482 reallocations that appear in the NODs, not revenue agent Camper's original Section 482 reallocations. In light of the basis for their findings, the failure of the Tax Court and the Sixth Circuit to distinguish between revenue agent Camper's results and those in the NODs were not significant.

ACA reached different results than those detailed in the NODs, and both ACA's results and those in the NODs differed from those of revenue agent Camper. In any event, the taxpayers were confronted with having to digest, on short notice, a methodology that differed from the Revenue Agent's and a set of results that differed from both the Revenue Agent's results and those in the NODs. After evaluating the methodology and results of ACA's transfer pricing study, the taxpayers then had to decide how to challenge them.

When the Commissioner abandons her Revenue Agent, and with it both the methodology supporting the NODs and their results, the Commissioner loses any presumption of correctness and bears an affirmative burden of proof. *Hull v. Commissioner*, 87 F.2d 260 (4th Cir. 1937); *Zarin v. Commissioner*, 92 T.C. 1084 (1989), *rev'd on other grounds*, 916 F.2d 110 (3rd Cir. 1990); *DHL Corp., et al. v. Commissioner*, TC Memo 1998-461 (1988).

Furthermore, where: (1) the determinations in the NODs are based on a different methodology than the Commissioner's trial expert; (2) the ultimate impact is a greater adjustment in tax (where the reallocation results in a smaller deduction); (3) the Commissioner fails to support her NODs at trial; and (4) the Commissioner relies on the trial expert's analysis of the case, then the Commissioner cannot contend that the adjustments in the NODs are reasonable: "Respondent cannot contend that the notice adjustments are "reasonable" on the one hand while adopting an analysis that rejects such adjustments as unreasonable on the other." *National Semiconductor Corp., et al.*, T.C. Memo, 1994-195 (1994). All four of these factors are present in the case at bar.

The instant case is on all fours with *National Semiconductor Corp., et al.* Approximately 30 days prior to trial, the Service produced the ACA transfer price study that employed a different methodology (time spent v. gross sales). ACA's study resulted in different reallocations than those proposed by revenue agent Camper. The Commissioner introduced no evidence regarding the methodology used to craft the NODs. And, the Commissioner relied solely and entirely on her trial expert's analysis of the case.

The Sixth Circuit addressed the issue of whether the Commissioner had abandoned her brief and nondescript NODs. They contained no analyses, computations, or explanation of the basis for the Section 482 reallocations. The sum and substance of each NOD was: 1) that the respective taxpayer's deductions for BKK's management fee was "paid under an agreement which [was] not at arm's length"; 2) that the BKK management fee was being reallocated "among the controlled corporations under Section 482", and; 3) that such action was "necessary to clearly

reflect the true taxable income of each controlled corporation and to prevent income manipulation." The reallocations in the NODs differed from revenue agent Camper's proposed Section 482 reallocations and there is no indication in the NODs of how the reallocations were computed.

In holding that the Commissioner had not abandoned her NODs, the Sixth Circuit cited the following commentary of Judge Halpren:

> Although the Moore [ACA] allocation differs from the amounts allowed by respondent in the notices of deficiency, respondent is *explicit* in stating that he has not abandoned the notice and, we believe, relies on the Moore allocation only to prove a reasonable allocation on the contingency that petitioners succeed in showing the respondent's allocation to be arbitrary, capricious, or unreasonable.

(APP 10 (Emphasis added.)).

The basis for Judge Halpren's observation is not obvious in the trial transcript. At trial, it seems that Judge Halpren was under the impression that the Commissioner had abandoned revenue agent Camper, from which one could reasonably conclude that the Commissioner had also abandoned its NODs. Consider the following question directed to revenue agent Camper and the comments of Judge Halpren as he interrupted the cross-examination:

> Q [MR. STEFFAN]: Did you [Ms. Camper] do an evaluation of what would be arm's length charges for the services that these people --

> THE COURT: Mr. Steffan, I don't see the relevance of this line of questioning. The [Commissioner] has not put forward the revenue agent's allocations as representing the market value [of the BKK services]. They've got an expert [ACA] who they say is going to do that who came up with different allocations than the revenue agent.
>
> MR. STEFFAN: That's true, Your Honor.

(TR 230, L 17-25, APP 38a).

By finding revenue agent Camper's testimony to be irrelevant, Judge Halpren adopted ACA's method, one which was inconsistent with the method employed in the NODs. The Commissioner concurred: "MS. HELFGOTT: Right. So our position is the position of our expert. To the extent that her position requires a concession on our part, that's our position." (TR 328, L 7-8, APP 47a).

The IRS would seem to be in a tenuous position if it had to admit: 1) that the only IRS employee it called as a witness during its case in chief, revenue agent Camper, computed Section 482 reallocations that differed from the Section 482 reallocations in the NODs, and; 2) that these two sets of Section 482 reallocations differed from those of the Commissioner's expert, ACA. The Commissioner may have been reluctant to disclose that it had three different sets of Section 482 reallocations. In any event, Judge Halpren dismissed the significance of the reallocations that he assumed (incorrectly) revenue agent Camper had proposed, *i.e.*, the Section 482 reallocations in the NODs.

Nothing in Judge Halpren's comments suggest that he considered ACA's position to be contingent in nature. These comments, standing alone, afforded the taxpayers a reasonable basis on which to conclude that the reallocations they needed to address for the remainder of trial were those of the expert ACA, not revenue agent Camper. Comments by the Government's trial attorney reinforce that conclusion:

> THE COURT: Ms. Helfgott, do the adjustments in the notice - well, let me put it this way. The notice - the adjustments in the notice of deficiency do not reflect the conclusions of your expert, do they?
>
> MS. HELFGOTT: Not entirely, Your Honor.
>
> THE COURT: Well, not exactly.
>
> MS. HELFGOTT: The position of Respondent is the allocation made by Respondent's experts as to the restaurant corporation [sic].
>
> THE COURT: Okay. In other words, you concede any excess of the adjustments - of the adjustments that would be made under Ms. Moore's allocations.
>
> MS. HELFGOTT: However that computationally shakes out for each deficiency at issue.
>
> THE COURT: Well, [ACA] has amounts that [it] thinks are the proper allocation and your

> revenue agent did the same thing, but they're different.
>
> MS. HELFGOTT: Right. So our position is the position of our expert. To the extent that her position requires a concession on our part, that's our position.

(TR 327-28, L 14-8, APP 47a).

Nothing in this exchange suggests that the Commissioner's position at trial was that of revenue agent Camper, and nothing in this exchange suggests that the position of ACA was merely a contingent position. It seems clear from this exchange that Judge Halpren believed that the Section 482 reallocations in the NODs were revenue agent Camper's. Had the taxpayers been given the opportunity to establish the contrary, the Commissioner would have been compelled to abandon the NODs at trial. This is because the only witness called by the Commissioner during her case in chief, revenue agent Camper, did not compute the Section 482 reallocations in the NODs and may have had no knowledge of how those reallocations had been computed. In any event, the Government's trial attorney did nothing to dispel Judge Halpren's apparent belief that the Section 482 reallocations in the NODs were computed by revenue agent Camper.

One more fact compels the conclusion that the Commissioner abandoned the NODs at trial. The Government's trial attorney conducted an extremely modest direct examination of revenue agent Camper and was unable to introduce any documents or substantive discussion of her reallocations. After interrupting Mr. Steffan's cross examination of revenue agent Camper, Judge Halpren

observed that the Commissioner had "not put in one wick of evidence" as to what revenue agent Camper did. (TR 231, L 3-4, APP 39a). It may well be that the Government's trial attorney had no desire to establish what revenue agent Camper did because it would reveal the differences in the Section 482 reallocations proposed by revenue agent Camper and those in the NODs. If so, the IRS had good reason to abandon its NODs and cast its fate with its expert, ACA.

The Sixth Circuit agreed with the Tax Court that the Commissioner had not abandoned its NODs and concluded that "the record does not support that either the [Commissioner] or ACA rejected revenue agent Camper's method in favor of [ACA's] time-based method." Interestingly, the Sixth Circuit made this observation in terms of revenue agent Camper's "method" and ACA's "method", not the "results" produced by their methods. In the case of Section 482 reallocations, it is well established that the reasonableness of the results obtained in a transfer pricing study outweighs the details of the methodologies employed to obtain the results. Furthermore, the fact that the Sixth Circuit refers to revenue agent Camper's method suggests that it was under the impression that revenue agent Camper's Section 482 reallocations were those set forth in the NODs.

If the Sixth Circuit meant "result" when it said "method" or if it meant to include the notion of a "result" in the notion of a "method", the taxpayers cannot appreciate how the record fails to support a rejection of revenue agent Camper's method (result) when: 1) the Government's trial attorney stated on the record that the Commissioner's position was that of its expert, ACA; 2) ACA's methodology and results clearly differed from those of revenue agent Camper, and; 3) the trial judge observed that the

Commissioner did "not put in one wick of evidence" as to what revenue agent Camper did.

In any event, if the Commissioner had abandoned the NODs, and substantial evidence supports that view, the NODs would lose their presumption of correctness. If that presumption had been lost, the taxpayers would then have been relieved of having to demonstrate that the Commissioner's reallocations were arbitrary, capricious or unreasonable.

Even were the Sixth Circuit correct in finding no abandonment, that does not end the inquiry. It is the taxpayers' position that the ACA testimony and report establish that the NODs are arbitrary, capricious or unreasonable. In short, when ACA's analysis is corrected to reflect actual events -- the dedicated 6000 annual hours of the Owners only -- ACA's report then arrives at substantially similar results to that of the taxpayers and well within the statistical ambit of the RMA Industry Guidelines which ACA used to establish arm's length prices.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to review the decision of the United States Court of Appeals for the Sixth Circuit as to the applicable burdens of proof, *i.e.*, a finding that *Eli Lilly & Co.* re presents the correct burdens of proof; a finding that the Commissioner abandoned the NODs and therefore the taxpayers met their first burden of proof and satisfied the second burden through its own testimony and that of ACA; or in the alternative, if the Commissioner is deemed not to have abandoned its NODS, the taxpayers carried its burden of proof that the NODs were arbitrary, capricious or unreasonable through their own and ACA's testimony; and further more that the taxpayers met the second burden of proof through their own and ACA's testimony. In any event, if the Commissioner is deemed not to have abandoned the NODS and if the taxpayers are deemed not to have carried its burden, the case should be remanded to the Tax Court for additional evidence to determine the correct transfer price.

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(Any footnotes trail end of each document)

Nos. 98-2416/98-2417/98-2418/98-2420

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Kenco Restaurants, Inc. (98-2416); K-K Restaurants, Inc. (98-2417); Tiffin Avenue Realty Company, Inc. (98-2418); Bryan Realty, Inc. (98-2420), Petitioners-Appellants,

v.

Commissioner of Internal Revenue, Respondent-Appellee.

December 10, 1999, Argued

February 16, 2000, Decided

February 16, 2000, Filed

COUNSEL:
ARGUED: John D. Steffan, STEFFAN & ASSOCIATES, Fairfax, Virginia, for Appellants.

Charles F. Marshall, U.S. DEPARTMENT OF JUSTICE, APPELLATE SECTION TAX DIVISION, Washington, D.C., for Appellee.

ON BRIEF: John D. Steffan, STEFFAN & ASSOCIATES, Fairfax, Virginia, for Appellants.

Charles F. Marshall, Teresa E. McLaughlin, U.S. DEPARTMENT OF JUSTICE, APPELLATE SECTION TAX DIVISION, Washington, D.C., for Appellee.

JUDGES:
Before: BOGGS and SUHRHEINRICH, Circuit Judges; POLSTER, District Judge. *

OPINIONBY:
SUHRHEINRICH

OPINION:

SUHRHEINRICH, Circuit Judge. The Commissioner of the Internal Revenue Service ("Commissioner") sent Petitioners notices of deficiency that reallocated fees Petitioners paid for management and administrative services. The notices of deficiency also imposed accuracy-related penalties. Petitioners filed separate petitions in the United States Tax Court seeking a redetermination of the deficiencies and accuracy-related penalties.

The tax court sustained the reallocations and penalties because Petitioners failed to overcome the presumption of correctness afforded to the notices of deficiency. Petitioners appeal. We AFFIRM.

I.

Petitioners-Appellants, Kenco Restaurants, Inc. ("Kenco"); K-K Restaurants, Inc. ("K-K"); Tiffin Avenue Realty Co., Inc. ("Tiffin"); and Bryan Realty, Inc. ("Bryan") (collectively "Petitioners"), are members of a commonly owned group of fourteen corporations (collectively "Group"). During the years 1990 through 1992, George Kentris ("G. Kentris"), Michael Kentris ("M. Kentris"), and Kenneth Baerwaldt ("Baerwaldt"), either individually or with their

wives (collectively "Owners"), owned equal shares of the Group.

Of the fourteen Group members, thirteen either own and operate one or more Taco Bell restaurants ("Restaurant Corporations") or own the real estate ("Realty Corporation") on which another member of the Group operates a Taco Bell restaurant. The following is a chart identifying the thirteen Restaurant and Realty Corporations:

Restaurant Corporations	Location	Realty Corporations
K-K	Findlay, OH	Tiffin
K-K	Findlay, OH	Tranton Ave. Realty
Kenco	Lima, OH	Harding Highway Realty
Kenco	Lima, OH	Allentown Road Realty
Bowling Green	Bowling Green, OH	Bowling Green
GMK	Defiance, OH	*unrealated corporation*
Perrysburg	Perrysburg, OH	Perrysburg
Wapak	Wapakoneta, OH	Apollo Drive Realty
Bryan Rest.	Bryan, OH	Bryan

The fourteenth Group member, BKK Management, Inc. ("BKK"), neither owns a Restaurant Corporation nor owns a Realty Corporation. Instead, BKK provides management and administrative services to the thirteen Group members and bills each Group member for these services. These services are not in dispute and, according to the tax court's opinion, include "accounting and administrative services, advertising, coordination and installation of Taco Bell menus, renovations, remodeling and repairs, building and equipment maintenance, insurance coverage, training, inspections, and contracting." *Kenco Restaurants, Inc. v. Commissioner, 1998 Tax Ct. Memo LEXIS 343, 76 T.C.M. (CCH) 512, 513, 1998*

T.C. Memo 342 (1998). The services are performed by Owners and BKK's support staff, and BKK pays their salaries. Baerwaldt and M. Kentris provide the operational management of the restaurants, and G. Kentris, an attorney, works half as many hours as the former two and is responsible for the Group's administrative and legal needs, which include payroll, contracts, finances, and legal matters.

All costs that BKK incurs for providing these services are allocated to Group members as a "management cost share" fee. These fees have two categories: payroll related (salaries, employment taxes, and health benefits) and incidental (office supplies, telephone charges, and rent). Approximately 85 percent of BKK's payroll related costs are attributable to Owners, and approximately 15 percent are attributable to the support staff.

Petitioners contend that BKK's payroll related costs were allocated according to the number of hours each Owner spent with each Group member. For an upcoming year, the Owners projected the hours they would spend with each Group member based on the hours they spent the previous year. Then, they adjusted their projections for upcoming projects and reevaluated them at midyear. However, the Owners did not maintain time logs or written documents recording their actual hours. Petitioners further contend that BKK allocated its incidental costs to Group members based on their consumption.

The fees that Group members paid to BKK are reflected in the following chart. To the right of each fee is the percentage that the fee represents of BKK's total annual fees.

		Reataurant Corporations		
		1990	1991	1992
Kenco	FEE / %	313,700.00/43/	413,000.00/4	389,000.0
**		0%	2/3%	0/33.5%
K-K**	FEE / %	279,650.00/39	283,500.00/29	380,600.

		%	%	00/32.9 %
GMK	FEE / %	9,100.00/1.0%	21,700.00/2.2 %	87,200.0 0/7.5%
Perrysburg	FEE / %	29,000.00/4.0 %	60,415.00/6.2 %	42,700.0 0/3.7%
Bowling Green	FEE / %	30,500.00/4.2 %	82,000.00/8.4 %	112,000. 00/9.7%
Wapak	FEE / %	0.00/0.0%	29,600.00/3.0 %	52,366.0 0/4.5%
Bryan Rest.	FEE / %	-	--	6,000.00 /0.5%

Realty Corporation

		1990	1991	1992
Tiffin**	FEE / %	28,000.00/3.9 %	31,000.00/3.2 %	26,000.0 0/2.2%
Trenton	FEE / %	12,000.00/1.7 %	14,500.00/1.5 %	16,100.0 0/1.4%
Allentown	FEE / %	2,000.00/0.3%	8,700.00/0.9%	11,100.0 0/1.0%
Harding Highway	FEE / %	18,000.00/2.5 %	24,000.00/2.5 %	25,000.0 0/2.2%
Apollo	FEE / %	3,000.00/0.4%	7,700.00/0.8%	7,200.00

				/0.6%
Bryan**	FEE / %	--	--	3,000.00 /0.3%

** Petitioners on appeal.

After an audit, IRS Agent Camper ("Camper") calculated the reallocations of BKK's management fees to reflect each Group member's yearly gross sales.[1] These reallocations decreased the share of BKK fees claimed by each Petitioner and thus decreased each Petitioner's deductions. Consequently, the lowered deductions increased each Petitioner's taxable income and created a disparity between the taxable income as represented by Petitioners and the taxable income as represented by the Commissioner's reallocations. The notices of deficiency that the Commissioner mailed separately to each Petitioner on June 13, 1995, reflect this disparity. The deficiencies and their accuracy-related penalties (20 percent) are illustrated in the following chart:

Petitioners	Year	Deficiency	Penalty	Total
Kenco	1990	$ 36,664.00	$ 7,333.00	$ 43,997.00
Kenco	1991	23,068.00	4,614.00	27,682.00
K-K	1990	35,056.00	7,011.00	42,067.00
K-K	1991	18,962.00	3,792.00	22,754.00
K-K	1992	21,304.00	4,261.00	25,566.00
Tiffin	1990	4,772.00	954.00	5,726.00

Tiffin	1992	4,124.00	825.00	4,949.00
Bryan	1992	174.00	35.00	209.00
TOTAL		$ 184,435.00	$ 36,887.00	$ 221,323.00

On August 18, 1995, Petitioners filed separate petitions in the United States Tax Court for a redetermination of the deficiencies and accuracy-related penalties. These petitions were consolidated at trial.

At trial, the Commissioner retained Sharon Moore ("Moore"), a business valuation expert with Alpha Consulting Alliance, to decide whether BKK's fee allocations were consistent with an arm's-length transaction. Moore determined that Petitioners' allocations were not arm's length and devised her own time-based allocations. To calculate these time-based allocations, Moore used the hours that each Owner and BKK employee spent in performing services for each Group member, which Moore obtained through interviews with Owners and BKK employees, rather than adopting Petitioners' method of using only Owner hours. Moore included the projected hours of a district manager, a maintenance man, and BKK's in-house accountant ("Borsani"). In contrast to Petitioners' allocations, Moore weighed Owner and employee hours equally because Moore found that both Owners and employees performed similar operational tasks. Moore then converted the total hours allocated to each Group member into a corresponding fee allocation and concluded that her time-based allocations were more consistent with an arm's-length charge than were Petitioners' allocations.

However, Moore's allocations pertained only to the six Restaurant Corporations. Moore neither addressed any fees

attributable to the Realty Corporations nor allocated any fees to Bryan Restaurant, Inc., which was created in 1992.

At trial, Petitioners disputed Moore's time-based allocations because Moore never considered special circumstances that varied the time that Owners dedicated to particular Group members. Specifically, these special events include a fire that demolished a Kenco restaurant in 1990, a scrape and rebuild of a K-K restaurant in 1990, a unique employment problem in 1990 (i.e., civil rights commission case filed by former employee), a worker's compensation claim in 1990, additions and remodeling of a K-K restaurant in 1991, land acquisitions and zoning litigation, dramatic decreases in sales caused by rumors of intentionally tainted food in 1992, and the development and opening of the new Bryan restaurant in 1992.

Petitioners also dispute Moore's time-based allocations because Moore included hours of modestly compensated, nonowner employees. Additionally, Petitioners dispute Moore's treatment of Owner's hours as equal to maintenance workers' hours. Moreover, Petitioners dispute Moore's inclusion of 2,000 hours for Borsani in 1992 because Borsani worked at BKK for only one month in 1992.

The tax court ruled in favor of the Commissioner and found that Petitioners failed to prove that the reallocations in the notice of deficiency, based upon gross sales, were arbitrary, capricious, or unreasonable. The tax court also sustained the Commissioner's imposition of accuracy-related penalties.

II.

We review factual findings of the tax court for clear error and legal questions de novo. See *Hoover v. Commissioner, 102 F.3d 842, 844 (6th Cir. 1996)* (citing *Conti v. Commissioner, 39 F.3d 658, 662 (6th Cir. 1994)).* We review mixed questions of law and fact under the "clearly erroneous"

standard. See *Eli Lilly & Co. v. Commissioner, 856 F.2d 855, 860-61 (7th Cir. 1988)* (citing *Standard Office Bldg. Corp. v. United States, 819 F.2d 1371, 1374 (7th Cir. 1987)).* Whether the Commissioner abused or exceeded his discretion in determining deficiencies against a taxpayer is a question of fact. See *Spicer Theatre, Inc. v. Commissioner, 346 F.2d 704, 706 (6th Cir. 1965);* see also *American Terrazzo Strip Co., Inc. v. Commissioner, 56 T.C. 961, 971 (1971).*

The first issue we address is whether the Commissioner abandoned the notice of deficiency. Petitioners contend that the Commissioner abandoned the allocations contained in the notice of deficiency at trial and instead relied upon Moore's reallocations. Also, Petitioners contend that the Commissioner has to establish the reasonableness of his adjustments because the burden of proof shifted when he abandoned the original allocations.

The Commissioner, however, contends that he never abandoned the notice of deficiency and that the purpose of Moore's testimony was merely to provide a reasonable allocation in the event Petitioners were successful in proving that the allocations contained in the notice of deficiency were arbitrary, capricious, or unreasonable.

Under current law, the Commissioner may rely on alternative theories supported by a different methodology than that used in the notice of deficiency. This reliance does not necessarily place the burden on the Commissioner or render the notice of deficiency arbitrary, capricious, or unreasonable. See *Altama Delta Corp. v. Commissioner, 104 T.C. 424, 458 (1995)* [**10] (citing *Sundstrand Corp. v. Commissioner, 96 T.C. 226, 354-355 (1991)).*

However, if the Commissioner abandons the notice of deficiency, then the notice of deficiency is no longer presumed correct, and all that remains is for Petitioners to show that the transaction was conducted at arm's length. See *DHL Corp. v. Commissioner, T.C. Memo 1998-461, 1998*

*Tax Ct. Memo LEXIS 461, *60, 76 T.C.M. (CCH) 1122, 1144 (1998).*

In the instant case, the tax court found that the Commissioner had not abandoned the notices of deficiency:

> "Although the Moore allocation differs from the amounts allowed by respondent in the notices of deficiency, respondent is explicit in stating that he has not abandoned the notice and, we believe, relies on the Moore allocation only to prove a reasonable allocation on the contingency that petitioners succeed in showing the respondent's allocation to be arbitrary, capricious, or unreasonable."

Kenco Restaurants, Inc. v. Commissioner, 1998 Tax Ct. Memo LEXIS 343, 76 T.C.M. (CCH) 512, 517, 1998 T.C. Memo 342 (1998).

Upon our review of the record, we agree with the tax court and find that the Commissioner did not abandon the notices of deficiency. The record does not support that either the Commissioner or Moore rejected Camper's method in favor of the time-based method. Also, as shown below in the second issue, the Commissioner had no reason to establish an arm's-length charge other than as a contingency argument in case Petitioners overcame the initial presumption.

The second issue we address is whether Petitioners have shown that the reallocations contained in the notice of deficiency are arbitrary, capricious, or unreasonable. Because deficiency notices have a presumption of correctness, Petitioners have the burden of overcoming this presumption by proving that their initial allocations were arm's length.

Petitioners contend that the Commissioner's reallocation method is arbitrary, capricious, or unreasonable for the following three reasons. First, the Commissioner's

methodology ignores the special situations that justified Petitioners' initial allocations. Second, Petitioners contend that their fee allocation is reasonable and arm's length because it represents the actual time spent on managing and operating each Group member. Petitioners further argue that these records were in fact created and monitored even though they were inadvertently destroyed. Third, Moore, the Commissioner's expert, conceded that Petitioners' method of allocating time was reasonable because Moore's method is identical and differs only as to hours.

The Commissioner contends that Petitioners have failed to show that the reallocations contained in the notice of deficiency are arbitrary, capricious, or unreasonable. In the alternative, the Commissioner contends that assuming we find the notices of deficiency arbitrary, capricious, or unreasonable, then Moore's time-based allocations represent an arm's-length charge. For this alternative contention, Commissioner asserts that Moore's allocations more properly reflect value added to each Group member.

Section 482 of the Internal Revenue Code and its regulations govern the instant case:

> In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses . . . .

I.R.C. § 482[2].

The "purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer . . . ." *Commissioner v. First Security Bank of Utah, 405 U.S. 394, 400, 31 L. Ed. 2d 318, 92 S. Ct. 1085 (1972).* If an arrangement between related parties differs from those reached in an uncontrolled, arm's-length dealing, the Commissioner may reallocate under section 482. See *Lufkin Foundry and Machine Co. v. Commissioner, 468 F.2d 805, 807 n.2 (5th Cir. 1972)* (citing *Spicer Theatre, 346 F.2d at 706).* This authority includes reallocating charges among controlled corporations for "marketing, managerial, administrative, technical, or other services" that do not represent an arm's-length charge. See Treas. Reg. § 1.482-2(b)(1).

Whether the notices of deficiency are arbitrary, capricious, or unreasonable depends, in part, on whether the charges were arm's length. If the charges were equivalent to charges made at arm's length, then Petitioners have satisfied their burden of proving that the notices of deficiency are arbitrary, capricious, or unreasonable. The regulations of section 482 govern the definition of an arm's-length charge.

If BKK's services are not an "integral part of the business activity," then an arm's-length charge is generally equal to the costs or deductions incurred in rendering such services. See Treas. Reg. § 1.482-2(b)(3). However, if BKK's services are an "integral part of the business activity," then the costs or deductions incurred are not an arm's-length charge. See Treas. Reg. § 1.482-2(b)(7). Rather, an arm's-length charge is "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts." Treas. Reg. § 1.482-2(b)(3).

Of the four situations that the regulations consider an "integral part of the business activity,"[3] the most applicable to the instant facts is Treasury Regulation 1.482-2(b)(7)(ii). In this section, "services are an integral part of the business activity of a member of a controlled group where the renderer renders services to one or more related parties as one of its principal activities." Treas. Reg. § 1.482-2(b)(7)(ii). Services are considered "principal activities" if the following two tests are satisfied. First, the renderer's cost of services[4] "attributable to the rendition of services for the taxable year to related parties" must exceed "25 percent of the total costs or deductions of the renderer for the taxable year [25 percent test]." Treas. Reg. § 1.482-2(b)(7)(ii)(a). Second, the facts and circumstances determine whether the rendition of services to related parties is one of the principal activities of the renderer ("facts and circumstances test"). See Treas. Reg. § 1.482-2(b)(7)(ii)(a). The regulations consider six factors:

> the time devoted to the rendition of the services, the relative cost of the services, the regularity with which the services are rendered, the amount of capital investment, the risk of loss involved, and whether the services are in the nature of supporting services or independent of the other activities of the renderer.

Treas. Reg. § 1.482-2(b)(7)(ii)(a).

We conclude that BKK's performance of services for other Group members is an "integral part" of its business activity and that an arm's-length charge is equal to "the amount which was charged or would have been charged" for same or similar services "in independent transactions with or between unrelated parties under similar circumstances."

Treas. Reg. § 1.482-2(b)(3). We reach this conclusion because BKK is a member of a controlled group and renders services as its principal activity.

The Group members are members of a "controlled group," as used in Treasury Regulation § 1.482-2(b)(7)(ii), because each Group member is a "controlled taxpayer." "Controlled taxpayer" is defined as "any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests." Treas. Reg. § 1.482-1(a)(4). In the instant case, Petitioners are controlled taxpayers because it is undisputed that they are commonly owned corporations and are owned equally by Owners. Also, BKK renders services to Group members as its principal activity because the parties have stipulated that the primary purpose of BKK is to provide services to Group members. Thus, both the "25 percent test" and the "facts and circumstances test" of Treasury Regulation § 1.482-2(b)(7)(ii) are satisfied.

Now that we have defined an arm's-length charge, we must next determine whether Petitioners have overcome two burdens of proof. Under the first burden, Petitioners must prove that the Commissioner's reallocations are wrong, because the notices of deficiency have a presumption of correctness. See *Welch v. Helvering, 290 U.S. 111, 115, 78 L. Ed. 212, 54 S. Ct. 8 (1933).* This presumption is overcome if Petitioners prove that the reallocations contained in the notices of deficiency are arbitrary, capricious, or unreasonable. See *Spicer Theatre Inc., 346 F.2d at 706;* see also *Eli Lilly & Co. 856 F.2d at 860.* To prove arbitrary, capricious, or unreasonable, Petitioners must show that their own allocations reflect an arm's-length charge. See *DHL Corp. & Subs. v. Commissioner, 1998 Tax Ct. Memo LEXIS 461, *60, 76 T.C.M. (CCH) 1122, 1145 (1998);* see also Treas. Reg. § 1.482-1(b). This is accomplished by providing evidence of similar transactions between uncontrolled

taxpayers. See *Lufkin Foundry & Machine Co., 468 F.2d at 808;* see also Treas. Reg. § 1.482-2(b)(3).

For this first burden, the Commissioner is not required to support the notice of deficiency with proof because courts generally do not examine the underlying motives or policy of the Commissioner's determination. See *Pasternak v. Commissioner, 990 F.2d 893, 898 (6th Cir. 1993).* Also, when determining whether the Commissioner's reallocation is reasonable, courts focus on the reasonableness of the result and not the details of the methodology employed. See *Seagate Tech., Inc. & Consol. Subs. v. Commissioner, 102 T.C. 149, 164 (1994);* see also *Bausch & Lomb, Inc. v. Commissioner, 92 T.C. 525, 582 (1989).*

Under the second burden, which only arises after Petitioners have satisfied the first burden, Petitioners "still have the burden of proving that their own allocation satisfies the arm's length standard." *Inverworld, Inc. v. Commissioner, 1996 Tax Ct. Memo LEXIS 291, 71 T.C.M. (CCH) 3231, 3237-62, 1996 T.C. Memo 301 (1996);* see also *Achiro v. Commissioner, 77 T.C. 881, 900 (1981).* If Petitioners fail to carry this burden, the tax court must determine a proper allocation based on the record. See *Inverworld, Inc., 71 T.C.M. (CCH) at 3237-62* (citing *Eli Lilly 7 Co, 856* F.2d at 860).

We conclude that Petitioners' allocations are not an arm's-length charge because Petitioners provide no evidence of an independent transaction between unrelated parties in similar circumstances. Also, the facts support our conclusion that Petitioners were not dealing at arm's length but were, instead, allocating their costs based on an ability to pay. Petitioners charged Wapak, a Restaurant Corporation, no management fee in 1990, but when its income increased in 1991 and 1992, so did its fees.[5] GMK's fees increased more than 900% between 1990 and 1992, and its share of the total fees increased by a factor of seven. However, no evidence was

presented that there was a corresponding increase in Owner hours. In 1990, Kenco required special attention to rebuild the restaurant. Yet, in 1991, the fee allocated to it was higher than 1990. There is no claim that K-K required special attention in 1992, but its fee was higher in 1992 than in 1991. Perrysburg was charged $ 29,000 in 1990, $ 60,415 in 1991, and $ 42,700 in 1992, but Petitioners provided no explanation, in terms of services, that would account for these differences.

The third issue we address is whether Petitioners are liable, under § 6662(a) of the Internal Revenue Code, for accuracy-related penalties due to their negligence. Petitioners contend that the facts do not support the imposition of negligence penalties because Petitioners never made adjustments based upon the ability or inability of a Group member to pay. However, the Commissioner contends that Petitioners allocated fees based on each Group member's ability to pay.

We review an imposition of § 6662(a) "negligence" penalties for clear error. See *Leuhsler v. Commissioner, 963 F.2d 907, 910 (6th Cir. 1992);* see also *Sacks v. Commissioner, 82 F.3d 918, 920 (9th Cir. 1996).* "Commissioner's assessment of a negligence penalty is presumptively correct, and the taxpayer has the burden of proving that an underpayment was not due to his negligence . . . ." *Leuhsler, 963 F.2d at 910.*

If there is an underpayment of tax on a return, a penalty in the amount of twenty percent of the underpayment is imposed. See I.R.C. § 6662(a). This applies to the portion of the underpayment that is attributable to negligence. See I.R.C. § 6662(b)(1). "Negligence" is defined to include "any failure to make a reasonable attempt to comply with the provisions of this title . . . ." I.R.C. § 6662(c). It has also been defined as a "lack of due care or a failure to do what a reasonable and prudent person would do under the

circumstances." *Hofstetter v. Commissioner, 98 T.C. 695, 704 (1992).* We find and conclude that Petitioners allocated BKK's management fees on the ability of each Group member to pay.

----------Footnotes----------

* The Honorable Dan A. Polster, United States District Judge for the Northern District of Ohio, sitting by designation.

[1] Camper testified that she used the gross sales method because Petitioners provided no actual time logs or any other information from which Camper could calculate the actual hours Owners spent with each Group member.

[2]Unless otherwise indicated, all section references are to the Internal Revenue Code and its Regulations that are in effect for the taxable years in issue.

[3] Subdivisions (i) through (iv) describe those situations that are considered an "integral part of the business activity." See Treas. Reg. § § 1.482-2(b)(7)(i) through (iv).

[4] Cost of services includes "all costs or deductions directly or indirectly related to the rendition of such services." Treas. Reg. § 1.482-2(b)(7)(ii)(b).

[5] The Tax Court suspected "that Wapak's insufficient cash-flow was the determinant factor in BKK's management decision not to allocate Wapak a management fee in 1990." We agree.

Tax Ct. Dkt. No. 15949-95. Docket No. 15950-95, 15951-95, 15952-95

UNITED STATES TAX COURT

KENCO RESTAURANTS, INC., ET AL.,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

KENCO RESTAURANTS, INC., ET AL.,[1]
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

September 24, 1998, Filed

COUNSEL:
Diane D. Helfgott, for respondent.

John D. Steffan, for petitioners.

JUDGES:
HALPERN, JUDGE.

OPINIONBY:
HALPERN

OPINION:

MEMORANDUM FINDINGS OF FACT AND OPINION

HALPERN, JUDGE: These cases have been consolidated for trial, briefing, and opinion. Respondent has determined deficiencies in income tax and accuracy-related penalties as follows:

Petitioner	Year	Deficiency	Penalty
Kenco Restaurants, Inc. (Kenco)	1990	$ 36m664	$ 7,333
	1991	40,311	8,062
	1992	23,068	4,614
K-K Restaurants, Inc. (K-K)	1990	35,056	7,011
	1991	18,962	3,792
	1992	21,304	4,261
Tiffin Avenue Realty, Co., Inc. (Tiffin)	1990	4,772	954
	1992	4,124	825
Bryan Realty, Inc. (Bryan)	1992	174	35

After concessions, the remaining issues to be determined are: (1) Whether respondent's reallocations of deductions among petitioners and certain other commonly controlled corporations under section 482 were necessary to clearly reflect the income of such corporations, and (2) whether petitioners are liable for the accuracy-related penalties imposed pursuant to section 6662.

Unless otherwise indicated all section references are to the Internal Revenue Code as in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

INTRODUCTION

Some of the facts have been stipulated and are so found. The stipulation of facts, with accompanying exhibits, is incorporated herein by this reference. At the time of the filing of the petitions in these cases, the principal places of business of all petitioners were in Ohio.

THE COMMONLY OWNED GROUP

Petitioners are members of a commonly owned group of 14 corporations (the group). Except for one member of the group, BKK Management, Inc. (BKK), each member of the group either owns and operates one or more Taco Bell restaurants or owns the real estate on which another member of the group operates a Taco Bell restaurant. BKK provides management and administrative support services to the other 13 members of the group. During the years at issue, each member of the group was owned in equal shares by George L. Kentris (G. Kentris), Michael N. Kentris (M. Kentris), and Kenneth J. Baerwaldt (Baerwaldt), either individually or together with their spouses. Messrs. G. Kentris, M. Kentris, and Baerwaldt were also the directors and managing officers of each member of the group (collectively, the owner-managers).

BKK MANAGEMENT, INC.

BKK was established as a "cost company", to provide management and administrative support services to the other members of the group (the purchasing members) at cost. Among the services BKK provided to the purchasing members were the following: accounting and administrative services, advertising, coordination and installation of Taco Bell menus, renovations, remodeling and repairs, building and equipment maintenance, insurance coverage, training, inspections, and contracting. BKK's costs, which were passed on to the purchasing members, included payroll-related costs (including salaries, employment taxes, and the cost of health benefits) and incidental costs (including office supplies, telephone charges, and rent). The payroll-related costs

represented the vast majority of BKK's costs in providing the management and administrative services to the purchasing members. Approximately 85 percent of BKK's payroll-related costs was attributable to the owner-managers. The remaining approximately 15 percent was attributable to support staff.

The owner-managers were employed by BKK to provide services to the purchasing members. They received salaries and certain other fees from BKK. They did not receive any other compensation for their services as officers or directors of the members of the group. Messrs. M. Kentris and Baerwaldt were full-time employees of BKK. Mr. G. Kentris, an attorney, who maintained an active law practice, worked part-time for BKK. All three owner- managers, however, received substantially identical salaries.

The owner-managers did not maintain time logs or written documents recording the hours that they spent working on behalf of any individual member of the group.

During the years at issue, in consideration of the services received from BKK, each of the purchasing members paid BKK a fee (the BKK fees). The following table lists the purchasing members and sets forth (1) the BKK fees paid during each of the years in issue and (2) the corresponding percentage that each such fee is of the total BKK fees for each year.

Members	1990		1991		1992	
Kenco *	$ 313,700	43.0 %	$ 413,000	42.3%	$ 389,000	33.5%
K-K *	279,650	39.0	283,500	29.0	380,600	32.9
Tiffin *	28,000	3.9	31,000	3.2	26,000	2.2

Bryan *	---	---	3,000			0.3
GMK, Inc.	9,100	1.0	21,700	2.2	87,200	7.5
Perrysburg Restaurants, Inc.	29,000	4.0	60,415	6.2	42,700	3.7
Bowling Green Restaurants, Inc.	30,500	4.2	82,000	8.4	112,000	9.7
Wapak Restaurants, Inc.	---	29,600	3.0	52,366		4.5
Trenton Avenue Realty, Inc.	12,000	1.7	14,500	1.5	16,100	1.4
Allentown Road Realty, Inc.	2,000	0.3	8,700	0.9	11,100	1.0
Harding Highway Realty, Inc.	18,000	2.5	24,000	2.5	25,000	2.2
Apollo Drive Realty, Inc.	3,000	0.4	7,700	0.8	7,200	0.6

Bryan Restaurants, Inc.	---	---	6,000			0.5
Total	$ 724,950	100%	$ 976,115	100 %	$ 1,158,266	100%

* Petitioners in these consolidated cases

OPINION

I. INTRODUCTION

Petitioners are members of a commonly owned group of 14 corporations (the group), 13 of whom (the purchasing members), during one or more of the years in issue, purchased management services from the 14th, BKK Management, Inc. (BKK). Each of the purchasing members deducted its payments to BKK for management services (the BKK fees). In order to clearly reflect the incomes of the purchasing corporations, respondent has reallocated the BKK fees among the purchasing corporations (generally, respondent's reallocation). Respondent has decreased the share of the BKK fees claimed by each petitioner. Petitioners argue that respondent's reallocation is arbitrary, capricious, and unreasonable. We must determine whether respondent abused his discretion in making his reallocation. We must further determine whether any underpayments of tax are due to negligence or disregard of rules or regulations.

II. REALLOCATION OF DEDUCTIONS

A. CODE AND REGULATIONS

In pertinent part, section 482 provides:

> In any case of two or more organizations, trades, or businesses * * * owned or controlled

> directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses. * * *

In pertinent part, section 1.482-1(b), Income Tax Regs., provides:

> "The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer."

In pertinent part, section 1.482-1(a)(6), Income Tax Regs., provides:

> The term "true taxable income" means, * * * the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. * * *

In pertinent part, section 1.482-2(b)(1), Income Tax Regs., provides:

> Where one member of a group of controlled entities performs marketing,

> managerial, administrative, technical, or other services for the benefit of * * * another member of the group * * * at a charge which is not equal to an arm's length charge as defined in paragraph (b)(3) of this section, the district director may make appropriate allocations to reflect an arm's length charge for such services.

Paragraph (b)(3) of section 1.482-2, Income Tax Regs., provides:

> ARM'S LENGTH CHARGE. For the purpose of this paragraph an arm's length charge for services rendered shall be the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts. However, except in the case of services which are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services * * * the arm's length charge shall be deemed equal to the costs or deductions incurred with respect to such services * * * unless the taxpayer establishes a more appropriate charge * * *

In pertinent part, section 1.482-2(b)(7)(ii)(A), Income Tax Regs., provides: "Services are an integral part of the business activity of a member of a controlled group where the renderer renders services to one or more related parties as one of its principal activities."

Section 1.482-1(a)(4), Income Tax Regs., provides: "The term 'controlled taxpayer' means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests."

B. BURDEN OF PROOF

Respondent's authority to make allocations under section 482 is broad. Bausch & Lomb, Inc. v. Commissioner, 92 T.C.

525, 581- 582 (1989), affd. 933 F.2d 1084 (2d Cir. 1991); Edwards v. Commissioner, 67 T.C. 224, 230 (1976); PPG Indus., Inc. v. Commissioner, 55 T.C. 928, 990-991 (1970). Respondent's section 482 determination must be sustained absent a showing that he has abused his discretion. Paccar, Inc. v. Commissioner, 85 T.C. 754, 787 (1985), affd. 849 F.2d 393 (9th Cir. 1988). The determination of whether respondent abused his discretion presents a question of fact, and petitioners bear the burden of proof. Rule 142(a). Indeed, in order for us to redetermine a deficiency attributable to section 482, petitioners bear the heavier than normal burden of proving that respondent's section 482 allocation is arbitrary, capricious, or unreasonable. Bausch & Lomb, Inc. v. Commissioner, supra; G.D. Searle & Co. v. Commissioner, 88 T.C. 252, 359 (1987); see also Altama Delta Corp. v. Commissioner, 104 T.C. 424, 456-457 (1995); Seagate Tech. Inc. & Consol. Subs. v. Commissioner, 102 T.C. 149, 163-164 (1994).

Neither the absence of tax avoidance motives, nor the existence of a business purpose, precludes respondent from reallocating costs under section 482 in order to reflect clearly the respective incomes of members of the controlled group. Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 215-216 (2d Cir. 1952) (dealing with 26 U.S.C. sec. 45 (I.R.C. 1939), the precursor to section 482), revg. and remanding on this issue, 16 T.C. 882 (1951); Eli Lilly & Co. v. United States, 178 Ct.Cl. 666, 372 F.2d 990, 998- 999 (1967); G.D. Searle & Co. v. Commissioner, supra at 359.

C. COMMON CONTROL

Petitioners are commonly owned corporations, owned in equal shares by the owners either individually or with their respective spouses, and are, thus, "controlled taxpayers" within the meaning of section 482. See sec. 1.482-1(a)(4), Income Tax Regs.

D. ARM'S-LENGTH CHARGES

The parties have stipulated, and we have found, that the primary purpose of BKK is to provide management and administrative support services to the other 13 members of the group. BKK provided such services to the purchasing members, and all of its costs were charged to the purchasing members as fees for those services. Thus, we find that BKK rendered services to related parties as one of its principal activities. As a consequence, rendering services was an integral part of BKK's business activity within the meaning of section 1.482-2(b)(7)(ii), Income Tax Regs. Because of that, the cost or deductions incurred by BKK with respect to the services rendered by BKK to the purchasing members (and passed through to the purchasing members) is not deemed equal to an arm's-length charge for those services. See sec. 1.482-2(b)(3), Income Tax Regs. Instead, an arm's-length charge is the amount that would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all the relevant facts (the independent transactions standard). Id.

Before concluding this discussion of arm's-length charges, it is important to note that we are not here concerned with the arm's-length charge for the totality of services provided by BKK to the purchasing members for each year (BKK's total yearly fees), which respondent does not challenge, but rather with the ALLOCATION of BKK's total yearly fees AMONG the purchasing members.

E. REASONABLENESS OF ALLOCATION

1. RESPONDENT'S REALLOCATION

Respondent's reallocation is reflected in the statutory notice of deficiency received by each petitioner. Each such notice contains one or more negative adjustments (depending on the number of years in issue) for "management cost share expenses". Those adjustments are explained in substantially similar language, as follows:

It is determined the management fee was paid under an agreement which is not at arm's length. Therefore, this expense is reallocated among the controlled corporations under section 482 of the Internal Revenue Code. This action is necessary to clearly reflect the true taxable income of each controlled corporation and to prevent income manipulation. * * *

Respondent called as a witness Diane Camper, a revenue agent for the Internal Revenue Service. Ms. Camper is responsible for calculating the adjustments respecting management cost share expenses set forth in the notices of deficiency. Ms. Camper was questioned on cross-examination about the methodology she used to make those adjustments. She testified that she made those allocations based on the gross sales of the purchasing corporations, making some adjustments with respect to time spent with respect to certain of the purchasing corporations that were merely real estate holding companies.

At trial, respondent called as an expert witness Sharon Moore. Ms. Moore is a certified public accountant and a senior appraiser accredited by the American Society of Appraisers. She is affiliated with Alpha Consulting Alliance (Alpha) and, along with others affiliated with Alpha, prepared a report that was offered as her expert testimony (the report). The report was prepared in response to respondent's request that Alpha opine as to whether BKK's management cost fee allocation represented an arm's-length price to each of the purchasing corporations. Ms. Moore was of the opinion that "the management costs allocated by BKK Corporation for managerial and administrative services are not accurately allocated based on value-add sic to the operating restaurant entities." Ms. Moore also reached a conclusion as to a fair allocation of such costs. Ms. Moore was accepted by the Court as an expert with respect to business valuation, and her report was received into evidence as her expert testimony.

2. PETITIONERS' ALLEGATIONS

Petitioners recognize that they must show that respondent abused his discretion: They must show that respondent's allocations are arbitrary, capricious, or unreasonable.[2] See, e.g., Bausch & Lomb, Inc. v. Commissioner, 92 T.C. at 582. Ms. Camper testified that she allocated BKK's total yearly fees among the purchasing members based primarily on gross sales, with some adjustments with respect to the realty holding corporations, which did not have any sales (respondent's method). Although petitioners allege that their allocation (which is based on the owner-managers' service hours) is reasonable, they have not directed any of their argument to proving that respondent's method produces an arbitrary, capricious, or unreasonable result, to wit, that gross sales is not indicative of management and administrative services provided. Petitioners do, however, make a collateral argument assaulting respondent's method, alleging that Ms. Camper did not take into account certain unusual events that occurred during the years at issue, which required BKK to provide unusual types and amounts of services to the affected purchasing members.[3] Ms. Camper testified that she considered allocation methodologies based on both hours and gross sales. Although she admitted that the "top" method would have been based on hours or time spent, she was limited by the information available to her. The owner-manager's failure to maintain time logs or other documentation recording the allocation of their time spent among the purchasing members, along with their failure to separately account for the time spent by support staff (whose activities gave rise to 15 percent of payroll-related costs), made it impossible for her to determine the impact of the unusual events on the services provided using an hour-based allocation methodology. Petitioners have, therefore, failed to prove that respondent's method, based as it was on gross sales, did not satisfy the independent transactions standard and, thus, reflect arm's-length charges for purposes of this

case. See supra sec. II.D. Further, petitioners did not even address the individual allocations resulting from respondent's method beyond arguing that they would be different had Ms. Camper's method weighed the unusual events more heavily. Finally, since the practice of the group was to separate real estate ownership from restaurant operation, the unusual events in question that involved the destruction or construction of improvements to real property (see supra, note 3), affected the real estate holding companies. n4 Ms. Camper testified that, in allocating management cost share expenses to the real estate holding companies, she took into account not only those members' gross sales (which were very low) but also some measure of the time spent with respect to those members. Undoubtedly, management time was necessary to deal with the destruction and construction caused by the unusual events and, to that extent, Ms. Camper did take account of the unusual events. Petitioners have not persuaded us that it was arbitrary, capricious, or unreasonable for Ms. Camper to deal with the real estate holding companies as she did, nor have petitioners proposed a formula for quantifying the value of any additional management and administrative services necessitated by such unusual events. Therefore, petitioners have failed to prove that the allocations resulting from respondent's method do not satisfy the independent transactions standard or reflect arm's-length charges.

Petitioners' principal engagement at trial and on brief was with Ms. Moore's allocation, apparently due to their belief that respondent had abandoned his method in favor of Ms. Moore's. Although the Moore allocation differs from the amounts allowed by respondent in the notices of deficiency, respondent is explicit in stating that he has not abandoned the notice and, we believe, relies on the Moore allocation only to prove a reasonable allocation on the contingency that petitioners succeed in showing the respondent's allocation to be arbitrary, capricious, or unreasonable. Having concluded

that petitioners have failed to carry their initial burden, we need not consider petitioners' criticism of Ms. Moores's allocation.

3. CONCLUSION

Petitioners have failed to carry their burden of proving that respondent abused his discretion; i.e., that the allocations resulting from respondent's method were arbitrary, capricious, or unreasonable. The management cost fee allocation determined in petitioners' notices of deficiency is therefore sustained.

III. ACCURACY-RELATED PENALTIES

In the case of an underpayment of tax required to be shown on a return, section 6662(a) and (b)(1) impose a penalty in the amount of 20 percent of the portion of the underpayment that is attributable to negligence or intentional disregard of the rules or regulations (hereafter, simply, negligence). Negligence has been defined as lack of due care or failure to do what a reasonable and prudent person would do under like circumstances. E.g., Hofstetter v. Commissioner, 98 T.C. 695, 704 (1992). Negligence includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return; it also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly. Sec. 1.6662-3(b)(1), Income Tax Regs.

Respondent determined penalties under section 6662(a) and (b)(1), and petitioners assigned error to those determinations. On brief, however, petitioners fail to identify those penalties as an issue in this case. We assume that petitioners principally rely on our finding no deficiencies in tax to avoid the penalties. In that tactic, petitioners are not successful.

Respondent's notices of deficiency do not particularize petitioners' negligence. On brief, respondent explains: "Petitioners were negligent in claiming deductions for management expenses that were solely based on petitioners' ability to assume the cost of such expenses, and that petitioners continued to do so even after they were informed by respondent's agents that the method of determining such costs was arbitrary." That explanation, at least the first clause, is not a model of clarity. We deduce that respondent's principal complaint is that petitioners were negligent in allocating the BKK fees on a basis that did not reflect the relative usage of BKK services by the purchasing members.

Ms. Moore was of the opinion that petitioners' method of allocating the management cost share fee did not satisfy a value added standard. Ms. Moore opined that each restaurant showed profitability consistent with industry averages before the management cost share fee allocation, but not after, concluding that petitioners' allocation distorted the individual store performances and did not clearly reflect the economic income of those locations.

Petitioners claim: "The representations of hours spent by the owner/managers is highly reliable and was neither rebutted nor impeached at trial." We assume that petitioners' claim is that the representation of hours spent by the owner-managers is reliable in the sense that it accurately reflects the hours spent with respect to each purchasing member. Petitioners state: "The time allocation was based on historical experience; was evaluated on a regular, on-going (almost daily) basis by the owner/managers; was evaluated and adjusted at midyear based on actual experience; and was recorded in contemporaneous records kept in computer spreadsheets." We, thus, assume that petitioners' implicit defense to the claim of negligence rests on the accuracy of their time allocations. Petitioners bear the burden of proof. Rule 142(a). Petitioners have not carried that burden.

Petitioners make much of the unusual events, which occurred during the years at issue, and which, petitioners claim, required BKK to dedicate unusual amounts of time to certain of the purchasing corporations. Those events, however, do not account for petitioners' allocations, and the record does not support petitioners' contentions that the owner-managers spent most of their time working on behalf of K-K and Kenco. Although no special projects required additional managerial attention for Kenco's restaurants in 1991, unlike in 1990, the management cost fee allocated to Kenco for 1991 was higher in absolute terms, and only slightly lower in relative terms, than the fee BKK charged to Kenco in 1990. Although petitioners do not claim that K-K required unusual management attention in 1992 as compared to 1991, its allocated fee was higher in both absolute and relative terms in 1992 than in 1991. It is telling that, between 1990 and 1992, GMK's management cost fee allocation increased more than 900 percent. That percentage increase substantially exceeds the increases in the management cost fee allocated to the other members of the commonly controlled group. In relative terms, GMK's share of the total BKK management cost fee allocation increased by a factor of seven. During that period, facts stipulated by the parties show that GMK's gross receipts increased substantially as well. During that period, there were no unusual events or other requirements of GMK that justified a substantial increase in management services required in 1991 and 1992 as compared to 1990.

Additionally, Perrysburg, which allegedly required minimal management services, was charged $29,000 in 1990, $60,415 in 1991, and $42,700 in 1992. Petitioners did not provide any explanation, in terms of services required by Perrysburg from year to year, that would account for those differences.

Finally, it defies explanation how Wapak was not allocated any of BKK's management costs in 1990.

Petitioners allege that BKK's management costs were allocated using an allocation methodology predicated on the number of hours that the owners spent at or on behalf of each of the commonly controlled corporations. Wapak was incorporated and operating a Taco Bell restaurant in 1990. We suspect that Wapak's insufficient cash-flow was the determinant factor in BKK's management's decision not to allocate Wapak a management cost fee in 1990.

Petitioners claim that contemporaneous records of time allocations "were actually created, maintained and used in making the Petitioners' allocations." Those records, petitioners claim, were inadvertently destroyed. The only evidence of contemporaneous time records was Ms. Borsani's and Mr. G. Kentris' testimony that Mr. G. Kentris' allocations of the owner-manager's hours for the upcoming year were recorded and served as the basis for allocating the BKK fees. Such forecasts, even if recorded, merely frame the problem, the accuracy of petitioners' estimates; the recording of estimates does not make them any more or less accurate.

Petitioners have failed to persuade us that the owner-managers, time allocations accurately reflected the hours spent by them with respect to each purchasing member. A close examination of petitioners' "unusual events" argument, along with a consideration of the allocations to Perrysburg and Wapak, convinces us that petitioners' allocations were, at best, what petitioners' counsel characterized them as during his examination of Mr. G. Kentris: a "guesstimation based on conversations between sic the owner- managers". Petitioners have failed to prove that they were not negligent in allocating the BKK fees according to petitioners' ability to "assume" the cost of such expenses. Respondent's determination of a section 6662 penalty is therefore sustained.

Decisions will be entered for respondent.

[1] Cases of the following petitioners are consolidated herewith: K-K Restaurants, Inc., docket No. 15950-95; Bryan Realty, Inc., docket No. 15951-95; Tiffin Avenue Realty Co., Inc., docket No. 15952-95.

[2] The case law interpreting sec. 482 illustrates that there is some ambiguity as to whether the taxpayer has the burden of proving that (1) the AMOUNT of the allocation proposed by the Commissioner is arbitrary, capricious, or unreasonable, or (2) the method or theory upon which the allocation was based is arbitrary, capricious, or unreasonable. Compare Perkin-Elmer Corp. & Subs. v. Commissioner, T.C. Memo. 1993-414 (theory was arbitrary, and capricious), with Sundstrand Corp. & Subs. v. Commissioner, 96 T.C. 226, 354 (1991) (result was arbitrary and capricious), and Eli Lily & Co. v. United States, 178 Ct. Cl. 666, 676, 372 F.2d 990, 997 (1967) (same). That ambiguity does not affect resolution of this case.

[3] The unusual events include: (1) A fire at one of Kenco's restaurants that burned the restaurant to the ground on Dec. 7, 1989, and the subsequent construction of a new, larger restaurant, (2) the owners razed Tiffin Realty's only restaurant and rebuilt a new facility in 1990, (3) the owners remodeled Bowling Green's only restaurant and expanded the dining room of K-K's restaurant located on Trenton Ave. in 1991, and (4) Bryan was incorporated on June 3, 1992, and Bryan's restaurant opened in Oct. 1992.

[4] For instance, it was Harding Highway Realty, Inc. and not Kenco, that incurred the loss from the fire, filed the claim, received the proceeds from the insurance company, sold the property and received the proceeds therefrom, and incurred the costs of building the new facility.

G. KENTRIS - DIRECT 81

matters, unemployment compensation matters; in this instance, claim of discrimination.

Q Anything that -- was it fair to say anything that came up requiring legal work, you were it?

A Correct.

Q Did the companies employ -- ever employ outside lawyers in 1990, 1991, and '92?

A I think you're the first outside lawyer we ever employed.

Q So, none in 1990, '91, or '92.

A Other than -- other than for title work. I mean, if we would buy a piece of property, we'd have a -- a title agent who would be an attorney conduct a title report.

Q When you are looking at a known prospective time-consuming event such as the fire at Harding, or at Kenco, how do you guesstimate or evaluate how much time, in hours, will be necessary to address the problem?

A Primarily in experience.

Q And these numbers were revised at somewhere around mid-year?

A Yes.

Q Okay.

In that revision process, what physically took place amongst and between the owners and employees to make those revisions?

G. KENTRIS - DIRECT 82

A Well, my father, Michael Kentris, and Ken and I meet on almost a daily basis or at least talk to each other

several times a week. So, I -- I'm probably the most well-informed of the three of us as far as knowing what all of us are doing.

I'm also, from a logistics standpoint, the guy who's in the office; they're in the field. During two of these years, Nancy Borsani worked under the same roof, and I would see her on almost a daily basis, sometimes more often.

So, when it came time to revisit the allocations, Nancy would have a fairly good idea of this, also, because she worked in the same office. I'm there every day. My father and Ken would be there often, several times a week, if not every day.

So, based on what had happened the previous six months, Nancy and I were, you know, cognizant of what was going on and what was in the works, and we'd make adjustments as needed.

Q The adjustments that occurred at mid-year -- were they significant adjustments in any areas?

A I don't know that they were drastic. When you say significant, I -- there wasn't anything that happened of great -- of such great magnitude that it distorted the whole half-year previous plan.

Q And in 1991, calendar year 1991, the -- were there

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hours or time spent. And since that wasn't available, I had to look at what else I had available to use.

There are other methods, but off the top of my head, I would say I didn't really purposely think through many, many methods.

Q Is part of your analysis predicated on relative sales, gross sales? Did you do any investigation or determination of the separate services that were being provided by the owner/managers to the related entities?

A In considering all of the entities and the type of operations that they had and the fact that there was a major fire in the first year and there were subsequent building at another location, plus the fire location, I did look at all those, trying to determine how in the world we could allocate, because those type situations would require more management skills, decision-making type processes.

Q Did you do an evaluation of what would be arm's length charges for the services that these people --

THE COURT: Mr. Steffan, I don't see the relevance of this line of questioning. The Respondent has not put forward the revenue agent's allocations as representing the market value. They've got an expert who they say is going to do that who came up with different allocations than the revenue agent.

MR. STEFFAN: That's true, Your Honor.

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THE COURT: And I don't want to tell you how to try your case, but you're making a case they didn't make. They have not put in one wick of evidence that what this woman did --

MR. STEFFAN: I understand.

THE COURT: -- represents fair market value. I mean, I couldn't find, from the basis of her direct testimony, that it did.

MR. STEFFAN: I understand that, Your Honor.

THE COURT: Okay.

MR. STEFFAN: May I have one moment?

THE COURT: Yes.

BY MR. STEFFAN:

Q Do you know what the year end is for BKK as opposed to the operating real estate corporations, their accounting period?

A My understanding is they're all year end.

Q Both of them are identical?

A Calendar year end. As far as I know.

Q BKK --

A Without looking, you know, this has been a long time ago.

Q Okay. I mean, if you don't remember, that's a fair answer. Thank you. Did any of the allocations that you made create a loss at any of the underlying companies?

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allocated the time of Unruh, Silver and Borsani in accordance with the same allocation, the allocation that you actually did on Kentris, Kentris and Baerwaldt, correct?

A Yes. I believe I've represented that we didn't make that simplifying assumption.

Q And you've testified that you haven't done any

7 weighting for the lesser paid non-owner/managers.
8 A No.
9 MR. STEFFAN: I have nothing further. Thank you,
10 Your Honor.
11 MS. HELFGOTT: I have nothing further, Your Honor.
12 THE COURT: Ms. Moore, I have a few questions.
13 Turn to page 11 of your report. Under the heading Fiscal
14 Analysis, the paragraph that begins "comparison between
15 locations on the basis of estimated valuation conclusions
16 appears to most closely support the allocations presented by
17 management." What does that mean?
18 THE WITNESS: Let me read that one more time.
19 THE COURT: Pardon?
20 THE WITNESS: Let me read that one more time. Oh,
21 okay. I think the point I was trying to make was that -- on
22 a big picture level -- was that we didn't challenge the
23 overall methodology based on time. We didn't feel like it
24 was implemented in a way that gave reasonable results. So
25 what I was trying to make is that implementing the -- using

1 a methodology based on time and using the information they
2 gave us, we felt like, in the way that we implement it, gave

a reasonable answer in terms of the value of the services that was calculated.

That doesn't appear to be very clear, but that was really the point I was trying to make; was that if we did the allocation using the methodology, but the way we implemented it, we thought we got good results.

THE COURT: So do I take it that one of your conclusions is that an allocation based on time is proper if time is accurately allocated to the costs?

THE WITNESS: If the time is accurately allocated and if the underlying services provided for are provided for at a reasonable dollar value. So I guess, yes, we're saying that I don't have a problem with allocating it based on time.

THE COURT: But here you didn't change the underlying dollar value because indeed that was fixed by your commission, wasn't it?

THE WITNESS: Oh, you mean the total dollar allocated?

THE COURT: Yes.

THE WITNESS: Correct. No, we didn't.

THE COURT: Nor per hour dollar allocation, because you didn't change the total number of hours, either.

You allocated the time --

THE WITNESS: Right.

THE COURT: -- based on percentages allocable -- of total time or each individual time actually allocable to each restaurant, right?

THE WITNESS: Right.
THE COURT: You accepted the number of hours.
THE WITNESS: Yes. That they provided to us?
THE COURT: That was provided to you.
THE WITNESS: Yes. Yes.
THE COURT: And you thought that was a reasonable number of hours overall, I take it.
THE WITNESS: Yes.
THE COURT: And since you were only allocating, I think, $900,000 worth of cost a year.
THE WITNESS: Well, it varied slightly with the year, but that's average, right.
THE COURT: Well, whatever it was. But you thought that was reasonable, too, I take it.
THE WITNESS: Well, let me --
THE COURT: It was fixed, at least.
THE WITNESS: It was fixed. We didn't question the total dollar amount that was allocated. That was outside the scope of what we were told to do.
THE COURT: So not having questioned the total

amount that was allocated and not having questioned the number of hours involved, you certainly then weren't questioning the dollar value per hour, because that was simply a product of division, wasn't it?
When you divide the number of hours into the dollars, you come out with a per hour allocation.
THE WITNESS: Yes. Per hour based on total hours, yes.
THE COURT: On the figures you were given.
THE WITNESS: Right. That's correct.
THE COURT: So I guess the conclusion -- just to

reemphasize this one more time and we'll come back to this in other parts of your report -- was the methodology of allocating overhead costs on the basis of hours allocable to each of the targets is a reasonable method of allocation. Is that your conclusion?

THE WITNESS: Yes.

THE COURT: Yes. Fine. And indeed that's one of the conclusions expressed in this badly written sentence.

THE WITNESS: Very badly written.

THE COURT: But that is one of the conclusions that's inherent in there. Go to page 13. I was somewhat puzzled by the table in that I didn't understand what the ratio was relating. In other words, I can see that Wapak is one-to-one, but what is the one? What are the ratios

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MOORE - RECROSS 303

same as net sales as calculated for the industry.

THE WITNESS: Yes.

THE COURT: Why do you make that assumption with regard to the management costs? In other words, what I'm getting at, it was only some of the management functions that were performed by BKK, right? I mean, some were performed at the store level.

THE WITNESS: This is true. That's true.

THE COURT: And so the ratio or the percentage of net sales to management cost allocated was a ratio of net sales to a sub-class of management costs, was it not?

THE WITNESS: Yes.

THE COURT: But isn't the ratio that you have for RMA industry guidelines a ratio of net sales to a different class of management costs; i.e., that class that was standard for management cost allocations for RMA?

THE WITNESS: Well, the RMA data is for officer compensation costs. So it's strictly upper management level. So that's why we felt that would be comparable.

THE COURT: So you think you could have corresponded to the --

THE WITNESS: Yes.

THE COURT: Okay.

THE WITNESS: Yes.

THE COURT: Fine. I didn't understand that.

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MOORE - RECROSS 323

THE COURT: And if indeed those charges related to the hours -- were related to the hours spent by the BKK personnel, you would have said I don't want to be billed on the basis of hours.

THE WITNESS: I guess I would say that, yes.

THE COURT: Right?

THE WITNESS: Right. I would like to pay for the benefit I received.

THE COURT: But it again strikes me that what you were doing is using certain financial analysis and industry

norms to criticize the results they got without being able to say with any degree of confidence that they simply didn't do things the way they said. That, simply put, they didn't allocate the hours the way they did. It's just that if they did that, they were bad businessmen.

You don't have anything to tell me as to how many hours each of these individuals actually spent with each of the stores. I mean, that's not -- there's nothing the matter with that.

THE WITNESS: No. I can't -- no. I can't -- that wold be -- I don't have any way to tell you that, no. I can --

THE COURT: What you can basically tell me is that an efficient group would not have allocated either -- would not have allocated hours in a way that produced these

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THE WITNESS: Right. And -- right -- and other trends, identification of trends within the corporations, yes.

THE COURT: But just to cross the T one more time. You can't say that they didn't spend those hours.

THE WITNESS: No, sir.

THE COURT: Okay. Mr. Steffan, do you have any more questions?

MR. STEFFAN: If I may have just one moment, Your Honor. No, I don't, Your Honor. Thank you.

MS. HELFGOTT: Nothing further, Your Honor.

THE COURT: Thank you.

[Witness excused.]

THE COURT: Do you have any further witnesses?

MS. HELFGOTT: No, Your Honor.

MR. STEFFAN: Your Honor, I have a two-minute rebuttal witness, Nancy Borsani.

THE COURT: Okay.

Whereupon,

NANCY BORSANI,

a rebuttal witness, was called for examination by counsel on behalf of the Petitioner and, having been previously duly sworn, was further examined and testified as follows:

DIRECT EXAMINATION

BY MR. STEFFAN:

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BORSANI - DIRECT 327

Q Okay. Have you ever driven from BKK headquarters to each of the Findlay stores?

A Yes.

Q And what's the mileage for each?

A It's about two miles.

Q Equidistant, both stores?

A Yes.

Q One way?

A Yes.

MR. STEFFAN: Thank you. Nothing further.

MS. HELFGOTT: Nothing, Your Honor.

THE COURT: Thank you.
[Witness excused.]
THE COURT: Ms. Helfgott, do the adjustments in the notice -- well, let me put it this way. The notice -- the adjustments in the notice of deficiency do not reflect the conclusions of your expert, do they?
MS. HELFGOTT: Not entirely, Your Honor.
THE COURT: Well, not exactly.
MS. HELFGOTT: The position of Respondent is the allocation made by Respondent's experts as to the restaurant corporation.
THE COURT: Okay. In other words, you concede any excess of the adjustments -- of the adjustments that would be made under Ms. Moore's allocations.

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328

MS. HELFGOTT: However that computationally shakes out for each deficiency at issue.
THE COURT: Well, she has amounts that she thinks are the proper allocation and your revenue agent did the same thing, but they're different.
MS. HELFGOTT: Right. So our position is the position of our expert. To the extent that her position requires a concession on our part, that's our position.
THE COURT: Okay. What about the corporations with negative adjustments, what happened to them?

MS. HELFGOTT: In terms of?
THE COURT: Where are they? Not in this case, are they?
MS. HELFGOTT: Well, we didn't determine a deficiency with respect to the corporations where we allocated a higher --
THE COURT: No, certainly you didn't, but --
MS. HELFGOTT: We advised them to file protective claims. We made those adjustments.
THE COURT: What did you do with regard to those, Mr. Steffan?
MR. STEFFAN: I'm sorry. I was taking some --
THE COURT: They made negative adjustments for some of the corporations which gave rise to deficiencies. They just told you that they made positive adjustments with

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MOORE - DIRECT 334

from this process, but I'll try again.
BY MS. HELFGOTT:
Q If, based on your interviews with the various personnel, you determined -- you interpret -- and the interpretation you made as to the interviews as to how they were spending your time, you concluded that they had spent 80 percent of your -- their time at the two largest corporations and that -- and not the allocation that you interpreted from your interviews, and then tested that allocation based on the operational statistics of each

corporation and industry data, would your -- what would your conclusion have been?

A My conclusion would have been, as it is now, that the charges allocated to the individual operating entities didn't represent, according to the statistics and the industry information, the arm's length value of those services. If we had been able to determine, based on your interviews with management, if they had been able -- if they had proven to us that they had records, if we knew that's how they spent their time, we probably would not have gone through the steps we went through to do this allocation. We would simply have said, okay, here's the dollar amount, let's test it and see if it's reasonable.

But since the records were not available to us, the first step that we did was try to recreate this

methodology and recreate this allocation and develop some relationship to hours.

So the conclusion whether or not we agreed with the hours would still be whether or not the dollar value charged to the individual operating entities represented, based on the information in our research, an arm's length value, and the answer in either case would have been no.

THE COURT: You see what I'm getting at? They started with the results and derived the number of hours that were appropriate for that result. They didn't start with the number of hours and answer the question as to whether those hours were spent. That's what I got from you,

isn't it, Ms. Moore?

THE WITNESS: No. No. I mean, I -- that's not what I intended to say. What I intended to say was that we attempted to evaluate the implementation of the methodology by doing it ourselves since there was no records available.

THE COURT: No.

THE WITNESS: Okay.

THE COURT: And Ms. Helfgott's question to you was start with the assumption that there is uncontradicted proof that 80 percent of the hours were indeed spent on the two largest stores.

THE WITNESS: Right.

THE COURT: That was -- was it not, Ms. Helfgott?